VZCZCXRO4609
RR RUEHAG RUEHROV
DE RUEHUP #1059/01 3111338
ZNY CCCCC ZZH
R 061338Z NOV 08
FM AMEMBASSY BUDAPEST
TO RUEHC/SECSTATE WASHDC 3544
RUCPDOC/DEPT OF COMMERCE WASHDC
RUEATRS/DEPT OF TREASURY WASHDC
INFO RUCNMEM/EU MEMBER STATES COLLECTIVE

C O N F I D E N T I A L SECTION 01 OF 03 BUDAPEST 001059

SIPDIS

DEPARTMENT FOR EUR/CE, EB/OMA, INR/EC
TREASURY FOR ERIC MEYER, JEFF BAKER, LARRY NORTON

E.O. 12958: DECL: 11/05/2013
TAGS: ECON EFIN PREL HU
SUBJECT: THE WOLF FROM THE DOOR...AND THE ELEPHANT IN THE
LIVING ROOM: FROM FINANCIAL STABILIZATION TO ECONOMIC REFORM

REF: BUDAPEST 954

Classified By: P/E COUNSELOR ERIC V. GAUDIOSI; REASONS 1.4 (B) AND (D)

¶1. (C) Summary. With the immediate crisis seemingly averted and with discussions underway with the IMF, EU, and the World Bank on the details of the international stabilization package, the economic debate in Hungary is beginning to shift toward a closer examination of the steps the government is proposing to meet the terms of the agreement, and to a broader discussion of economic reforms needed in Hungary. Given the minority government's relatively weak position and the return to politics as usual in Hungary, it is uncertain whether deeper economic reforms beyond steps required to meet stabilization package requirements will be achieved in the near term. End summary.

A BAD MOON RISING

¶2. (SBU) Most economists and analysts believe the financial stabilization package for Hungary is large enough to help Hungary meet its public and private financing needs through the end of 2009, and that the size of the package and speed of its negotiation have sent a positive signal to help restore a degree of investor confidence. Indeed, market reactions over the past week have been largely positive, with both the forint and the stock exchange showing signs of stabilizing and recovering some of the value lost in recent weeks.

¶3. (C) Many caution, however, that Hungary's acute vulnerability reflects much deeper economic problems that, if not addressed, could lead the country back to the precipice of significant capital flight. Throughout our recent and extensive survey of economic analysts and business contacts, most have argued that the stabilization package should not be seen as a safety net, but rather a springboard for reform. Furthermore, they believe that Hungary only has a limited window in which to address these issues.

LOOKS LIKE WE'RE IN FOR NASTY WEATHER

¶4. (C) As economic analysts begin looking beyond disaster aversion to the effects of the global financial crisis on the real economy, many believe Hungary faces a difficult road ahead. Although the EU currently forecasts growth for Europe resuming as early as the third and fourth quarters of 2009, even the government considers this to be optimistic, and many predict that Western Europe's demand for Hungarian exports will not recover so quickly. October exports declined 7 percent year-on-year, the largest drop in over five years. Lower domestic consumption is also expected as a result of austerity program measures reducing real incomes. Together with shrinking export markets, this could cause a sharp increase in unemployment, with some estimating as many as

300,000 newly unemployed.

¶5. (U) Indeed, manufacturing has already been affected, with a number of factories and businesses announcing layoffs, production line interruptions, and closures. Industrial output fell 2.4 percent in September. Recent layoffs contributed to a 0.2 percent increase in unemployment, and this trend is expected to continue. Moreover, the reduced availability of credit will continue to affect businesses, and new construction continues to slow. Retail sales figures are also down as domestic consumption levels drop, along with consumer confidence and the purchasing index.

¶6. (C) Although the government is proposing new measures to help SME's and to increase public works projects, there is increasing concern that austerity measures and growing economic dislocation could cause greater levels of labor unrest. The presumption that the crisis was "created" in foreign countries to benefit foreign companies is already in the air, and political analysts caution that it may give rise to an increase in right-wing extremism.

I HEAR HURRICANES A BLOWING

¶7. (U) In order to meet deficit reduction requirements in the IMF package, the government has announced a series of measures, including the institution of a freeze on public sector wages, eliminating next year's 13th month bonus, and limiting the amount of 13th month pensions, as well as the number of people who qualify for it. In addition, the government announced plans to dedicate existing EU development funds to support SMEs (1,000 billion HUF) and to

promote a major public works campaign (1,800 billion HUF).

¶8. (C) Many analysts believe that these measures do little, however, to address underlying causes of anemic growth in Hungary. Despite assurances by Minister of Economy Gordon Bajnai that the government is ready to pursue reforms in areas including party finance and public administration, many remain skeptical of both the minority government's ability as well as its intentions. Although his poll numbers have recovered slightly over the past two weeks of crisis management, Prime Minister Gyurcsany still lacks the personal credibility and the political capital to marshal the two-thirds majority in Parliament required by most structural reforms. With the 2010 national elections just 18 months away, betting here is that the government will walk back on additional austerity measures now under discussion by next year.

¶9. (SBU) There is a surprising amount of agreement among policymakers and economic analysts about why Hungary has been Central Europe's slowest economic performer in recent years. They note that the country's high taxes on labor and one of the highest redistribution rates in Europe continue to stifle economic growth. The current tax, pension, and social benefit systems do not incentivize employment, and contribute to Hungary having one of the lowest labor participation rates in the EU. An oversized bureaucracy and high levels of tax avoidance burden the government budget and make spending cuts and the reduction of Hungary's large national debt more difficult. Finally, many believe that the political party finance system contributes to corruption and a lack of trust in public institutions (reftel).

¶10. (SBU) Many believe that Hungry must address these issues now, or else risk falling further behind other countries in the region. FIDESZ-era Finance Minister and former Central Bank Governor Zsigmond Jarai maintains that the economic policies of the current government are causing foreign investors to seek opportunities elsewhere, and leads foreign companies already in Hungary to repatriate a higher percentage of their profits. He notes that foreign companies in Hungary only reinvest around 30 percent of profits, which

is significantly lower than Slovakia (over 50 percent), or the Czech Republic (approximately 60 percent). Analyst Tamas Vojnits also notes that FDI levels in Hungary have begun decreasing, and prominent development mogul Sandor Demjan - who now focuses solely on investments abroad - predicts that Hungary will become "the poorest European nation in 15 years without structural reform."

...THE VOICE OF RAGE AND RUIN

¶11. (C) Despite initial hopes, the financial crisis failed to lead to a new national consensus on the way forward. During negotiations with the IMF, government attempts at achieving buy-in from other parties appeared limited to achieving enough support to be assured successful passage of stabilization package-related measures in Parliament. Major opposition party FIDESZ, after initially limiting its criticism of the IMF deal, has resumed its criticism of the MSzP for both the specifics of the package as well as the secrecy in which it was negotiated. To date, the opposition has criticized the stabilization package on several grounds, denouncing it variously as a "shameful loss of sovereignty" and as an "insufficient impetus for reform."

¶12. (SBU) Although FIDESZ Parliament Budget and Finance Director Mihaly Varga agrees that the IMF package was necessary in order to halt a possible contagion effect in the region, he is doubtful that the government will enact structural reforms that will help economic growth in Hungary. He said that the IMF has been misled into believing this is a financial crisis only, and everything else is OK. But when welfare expenditures increased to 25 percent of the budget, and pensions are 11 percent of GDP, and it is more attractive to be on welfare than to work, the economic problems run alot deeper than the financial crisis. Former FIDESZ Finance Minister Jarai also expressed doubt that the government will take on reforms with a year and a half remaining prior to elections, and cautioned that "unless Hungary solves the underlying economic crisis, we will face another financial crisis."

¶13. (C) But FIDESZ has stopped short of offering a detailed and comprehensive alternative. Last week Mr. Varga told the Ambassador that Hungary should seek even greater reductions in the deficit, and identified local and community

governments as an opportunity for cost reductions, but at the same meeting indicated his party "can't support freezing wages." Mr. Jarai went even further, commenting that the government should not just reduce the size of the deficit, but should work toward a budget surplus in order to reduce the level of government debt. At the same time, however, a growing chorus of FIDESZ MP's like Debrecen Major Lajos Kosa criticize the cuts the government is proposing as taking away money from families, pensions, and healthcare. Still others tell us privately that the party would have been amenable to supporting the package in exchange for the government's commitment to call early elections or replace the prime minister.

PAIN WITHOUT GAIN

¶14. (C) Comment. By Hungarian standards, the government acted quickly and decisively in reaching an agreement with international financial institutions to address Hungary's immediate financing problems. As the opposition readily points out, however, the underlying causes of the problems are largely of the government's own making. Although the PM has made reference to austerity measures as being "the first phase" of a "long crisis," now that the country appears to be out of immediate danger, many in the diplomatic community fear the government may content itself with doing the bare minimum on austerity measures in keeping with the stabilization package requirements. But further reforms are necessary - and even convenient with the International

Community as the logical scapegoat. A course of inaction from the GOH could be the last straw for foreign investors who fear that the government has not recognized the origins or the extent of the problem. As one senior AmCham official cautioned, the GoH risks appearing foolish - or of taking investors for fools. Even with foreign aid available in the near-term, it can ill afford to further alienate foreign investment by continuing what FIDESZ Parliamentary Faction Leader Tibor Navracsics describes as a pattern of "wasting one day at a time." End comment.
Foley